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Market reality splits European and

Antonio Borges, chairman of the Hedge Fund Standards Board, contrasts current and future policy towards hedge funds in the US and Europe – and assesses the long-term consequences of proposed new measures either side of the Atlantic for financial markets, the financial system, the economy and global investors

As the new regulatory framework for the financial system begins to take shape, a striking contrast between North American and European views is emerging — creating some strains in transatlantic cooperation and leading to substantial long-term consequences for the development of markets.

In the US, the focus is mainly on the banking system. Hedge funds will be regulated, the SEC will have new powers and no manager will be able to escape completely from the oversight of the regulator.

But these are relatively minor novelties: many hedge fund managers already voluntarily register; and the SEC is actually taking great care — including listening to advice from countries where registration and information requirements have been in place for many years — in order to do things right.

By contrast the reforms to banking regulation are likely to be radical, with some form of the Volcker rule put in place to separate so-called "boring" deposit-taking banking from the more sophisticated and risk-prone activities that universal banks now engage in — essentially in their proprietary trading.

The basis of the rule is the idea that more risky activities should be left for market specialists — like hedge funds and private equity — which are better positioned to deal with them and create virtually no systemic risk.

In other words, the US regulatory philosophy recognises that the financial system has many responsibilities, and wants to allocate them in a division of labour that is more robust than what we have had until now.

Whatever the merits of the Volcker rule or the difficulties it creates, it is interesting to note that the American regulatory approach recognises the value that market specialists contribute and is prepared to segment the markets accordingly.

It is noteworthy that this leaves increased margin for more stringent regulation of banking: if banks become more costly to operate and more limited in the range of services they offer, other market participants can step in — with less adverse consequences for the overall economy.

In Europe, the regulatory rhetoric could not be more different. Market specialists like hedge funds and private equity are being depicted as the source of all financial evil, there is pressure to curtail their activities and some politicians would be happy if they disappeared altogether.

This in large part reflects a deep mistrust of financial markets in continental Europe. As governments face up to the consequences of bankrupt public finances in some countries and a totally inadequate collective response to the challenges they create, the last thing politicians want is to face the sanction of the markets.

And hedge funds, because they are the leading edge of those markets and a symbol of the power markets have to respond to financial recklessness, will always be the preferred target of political abuse.

A string of recent studies, including from some of Europe's top regulators, have rejected the notion that widening spreads of Greek debt are caused by a speculative attack against the country. What is driving bond prices down is simply legitimate fear on the part of cautious long-term investors, like banks and insurance companies. But in the current political environment, facts are irrelevant; only political expediency matters.

The consequences of this approach are not immediately obvious. In the long term, markets will always force a return to reality. As new banking regulation — such as a bank levy, higher capital requirements and liquidity constraints — make it more onerous, market-

Antonio Borges, chairman, Hedge Fund Standards Board

Antonio Borges was appointed chairman of the Hedge Fund Standards Board in June 2008. Formerly he was vice chairman of Goldman Sachs International from September 2000, where his responsibilities included investment banking, leadership development and strategy.

Prior to this he was Dean of INSEAD from 1993 to 2000. He originally joined INSEAD's faculty in 1980 and also taught at the University of Lisbon, the Portuguese Catholic University and Stanford University.

Between 1990 and 1993 Borges was vice governor of Banco de Portugal, where he took a leading role in the liberalisation of Portugal's financial system. He also worked at European level on the project of Economic and Monetary Union.

He graduated from the Technical University in Lisbon and holds his MA and PhD in Economics from Stanford University.

He has been a consultant to the US Electric Power Research Institute, the US Treasury Department, the OECD and the Portuguese government. He was a board member of Citibank Portugal, Petrogal-Petroleos de Portugal, Vista Alegre Group, Paribas, Sonae and Cimpor-Cimentos de Portugal.

He is currently on the boards of Jerónimo Martins and Sonae.com and is a member of the supervisory board of CNP Assurances. He chairs the audit committees of Banco Santander Portugal and Banco Santander de Negocios Portugal. He is on the advisory boards of several European and US corporations and foundations and is chairman of the European Corporate Governance Institute.

He is a member of the European Corporate Governance Forum set up by the European Commission to examine best practices in member states with a view to enhancing the convergence of national corporate governance codes and providing advice to the Commission.

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US policies towards hedge funds

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Antonio Borges

based direct finance will necessarily develop, leading to a financial system more similar to that in the US.

But because this development of financial markets is not welcome by the authorities, there is a chance that many of these trends will be less managed, less coordinated and with somewhat unpredictable long-term consequences. In 10 years time Europe may look very different from how it does today.

Similarly, the consequences of European hostility towards hedge funds may have many unintended consequences, some of them the exact opposite of what European politicians say they want. As the notorious EU directive on Alternative Fund Managers has shown, the kind of hard line, restrictive rules to constrain hedge funds that were initially proposed are simply not workable given the nature of the industry.

So what is left is a combination of some rather innocuous provisions together with very dangerous measures to close the European market and some nonsensical ideas on compensation.

In the short term this may actually be in the interests of the very large funds which can easily cope with the costs of compliance and may enjoy some additional monopoly power over their investors.

In the long run, however, nobody gains from protectionist markets while antagonising investors and increasing barriers to entry in the industry may seriously damage the future development of European capital markets.

What could have been a good opportunity to improve market integration and actually extend the principles of the single market to alternative investments looks like ending up as one of the worst pieces of EU legislation in a long time.

Markets will eventually restore rationality, simply because of the power of supply and demand. As market volatility returns, serious long-term investors remember how valuable hedge funds can be. It is precisely when markets are difficult and hard to predict that the value of more sophisticated strategies becomes clearer.

Although absolute return strategies are always difficult to deliver, these strategies prove their worth in unpredictable markets like today’s – markets in which, for example, sovereign debt has become the riskiest of all asset classes.

The hedge fund industry is the cradle of financial innovation directed at meeting investors concerns and preferences. Those who believe in a mainstream, high reputation hedge fund industry – be they managers or investors – need to recognise that they have a responsibility for ensuring that the industry adheres to the high standards that are the core of a mature sector, operating in the collective interest of investors and the wider economy.

The hedge fund standards can help to complement statutory regulation and in many areas standards can be more effective than legislation in influencing and changing behaviours. However, the danger that the European industry faces is that in the current mood reason and rationality may not always prevail. There is still a risk that specific regulatory provisions and interventions could create havoc in the industry and make life very difficult for managers and investors.

The repeated anger at short-selling, which seems to periodically energise European politicians, is an example of how misguided policies can put Europe at a great disadvantage in a financial world which is more and more global. It is also an example of how counterproductive such measures can be.

As European governments face growing difficulties in selling sovereign debt, they will soon learn that it is not in their interest to damage the interests of the very investors who might buy their bonds. Eliminating the ability of investors to protect themselves against risk is no way to increase the demand for assets that are legitimately perceived as high risk.